

**Summary of Testimony of  
Chairman James J. Hoecker  
Federal Energy Regulatory Commission  
before the  
Subcommittee on Energy and Power  
Committee on Commerce  
United States House of Representatives**

**September 11, 2000**

California pioneered the restructuring of wholesale and retail power markets, in the belief that competitive markets would reduce high rates in the State and promote access to reliable and reasonably priced power. The blueprint for California's markets was laid out in AB 1890 in 1996. The Commission has worked closely with the State to implement its chosen approach.

This past summer, California's wholesale power markets have produced exceptionally high prices for energy and ancillary services. Where flowed through directly to retail customers in the State, these price increases have raised retail rates and caused economic hardship to many California citizens and businesses. The Commission is acting to address the issues presented in California by upholding purchase price caps, investigating operating conditions in California's wholesale power markets and adopting a refund effective date. The Commission will correct any market flaws or unlawful behaviors to the extent it has authority to do so.

A number of possible causes for the sharp price increases are commonly cited. Among these are not enough new generating facilities, rising demand for electricity, lack of hedging by wholesale buyers, unusually hot weather over a large region, inefficient market rules, and, according to some observers, collusion or other anticompetitive behavior by generators.

Without prejudging the results of our investigation, my preliminary view is that California's wholesale prices are primarily the result of a critical imbalance of supply and demand. Wholesale market rules and structure may have exacerbated the resulting price increases. However, the Commission is still investigating these markets. When we have a sufficient record of market conditions, the Commission will take further action to address problems to the full extent of our jurisdiction.

Finally, it appears clear that the transition to competition will be swifter and more painless where adequate supplies of power are already available. Because traditionally regulated markets did not keep pace with changing demands for electric power, restructuring (at least in California) has started with a major disability. I believe, therefore, that enactment of Federal restructuring legislation will reduce the uncertainty associated with restructuring that may be inhibiting investments in new generation and transmission capacity. Such legislation should address the need for comparable and open access to transmission facilities, regional transmission organizations, mandatory reliability rules, and tools for remedying market power.

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Mr. Chairman and Members of the Subcommittee:

Good morning. I am James Hoecker, Chairman of the Federal Energy Regulatory Commission (Commission). Thank you for inviting me and the other members of the Commission to participate in today's hearing on recent developments in California's electricity markets. I commend Chairman Barton and the members of this Subcommittee for responding quickly and constructively to the plight of southern California ratepayers and I want to assure the Subcommittee that the Commission is prepared to take appropriate action based on a factual understanding of what went wrong and to work hard to ensure that competition brings benefits, not risks, to consumers in the future.

I want to stress four key points:

1. The Commission is very concerned about high electricity prices in California and their effect on consumers. The Commission is actively investigating the causes of high wholesale market prices, and is committed to taking prompt action to correct identified problems.
2. Since California's 1996 enactment of landmark legislation establishing electric retail competition (AB 1890), the Commission and the State have cooperated in restructuring power markets in California. California's restructuring legislation affected matters within the Commission's jurisdiction. However, the Commission chose at the time to work hard to give deference to the State's approach to restructuring and to implement the

State's approach to restructuring on an aggressive schedule. It is still unclear whether this summer's events require fundamental changes in that approach, but we should be willing to make them if necessary.

3. Possible causes for the sharp price increases include insufficient additions of new generating facilities, rising demand for electricity, lack of hedging by buyers, unusually hot weather over a large region, inefficient market rules, and, according to some observers, collusion or other anticompetitive behavior by generators. While our investigation is not complete, my preliminary view is that California's markets are being affected primarily by an imbalance of supply and demand, and that wholesale market rules and structure may have exacerbated the resulting price increases.
4. The Commission has responded to these events by approving programs for eliciting voluntary load reductions from customers on peak days, rejecting a challenge to the decision of the California Independent System Operator Corporation (ISO) to lower its payments to power sellers, and initiating a fact-finding investigation as well as a formal proceeding with refund protection. However, the Commission has limited ability to relieve the immediate customer crisis. Important aspects of this problem are a State responsibility, such as authorizing construction of new generation and transmission facilities. Moreover, plans for competitive bulk power markets in the long-run would be aided immeasurably by Federal legislation.

## **I. Restructuring in California and the Commission's Role**

AB 1890 radically restructured the electric industry in California. Prior to enactment of AB 1890, most electricity consumed in California was supplied by vertically-integrated utilities with franchise service territories. These utilities owned power plants to generate the electricity, as well as transmission and distribution facilities to deliver the power to customers. The utilities were required to serve the retail customers within their territories, and retail customers within those territories were required to buy from those utilities.

AB 1890 "unbundled" the traditional service of California's three major investor-owned utilities, creating a new structure and new institutions to allow competition for retail power sales. Under AB 1890, generators may sell power directly to customers or into the markets operated by a new entity created under AB 1890, the California Power Exchange Corporation (PX), except that the three major utilities were required to buy and sell exclusively through the PX for a period of time. Operational control of the high-voltage transmission facilities of the three major utilities was transferred to the California ISO, another new entity created under AB 1890. The three utilities divested most of their generation assets in response to State stranded cost incentives, but they continue to provide distribution services within their franchise territories.

Under AB 1890, the retail rates of California's three major utilities were frozen until they finished recovering their stranded costs, through a Competitive Transition Charge. Last year, San Diego Gas & Electric finished recovering its stranded costs and its rates were no longer frozen. The rate shocks occurred when this utility, after fully recovering its stranded costs, continued to buy all of its power through the California PX at spot (short-term) prices and immediately flowed through these high short-term prices to retail customers.

The Commission's primary role in electricity markets under the Federal Power Act (FPA) has remained unchanged since the 1930s. FPA Sections 205 and 206 give the Commission jurisdiction over the rates, terms and conditions of sales for resale of electric energy and transmission service in interstate commerce by public utilities. FPA

Section 203 gives the Commission jurisdiction over public utility transfers of ownership or control of facilities used for these services. Public utilities regulated under FPA sections 203, 205 and 206 include investor-owned utilities but exclude government-owned utilities (such as the federal power marketing agencies and municipal utilities) and most cooperatively-owned utilities.

Developments in the market itself, such as competitive generation by non-traditional utilities, have made the wholesale market more competitive, dynamic and commercially important. The unbundling of services in California expanded the Commission's role in California's electricity markets. Both the California ISO and the California PX are public utilities, and their sales for resale and transmission services are within the Commission's jurisdiction. Additionally, the three major utilities in California are public utilities, and their sales for resale and transmission services also are within the Commission's jurisdiction.

For over four years, the Commission has made a significant investment of resources in carrying out the fundamental mechanisms of AB 1890. We issued extensive orders authorizing the initial creation of the ISO and PX and, since then, have acted on almost 30 filings by the ISO alone to amend various rules and procedures. Often, the Commission has been asked to expedite action on these matters in order to address problems needing quick attention, and we have done so consistently. In addition, the Commission has deferred to the policy choices made by state legislators, regulators and stakeholders in the California restructuring, such as the total separation of the ISO and

PX, a requirement that the three major IOUs buy and sell electricity exclusively through the PX's short-term markets, a requirement that the ISO rely exclusively on short-term markets to obtain reliability services, a governance board for the ISO and PX consisting of representatives from defined stakeholder groups and a state-appointed oversight board for these two entities.

We deferred to these choices in part because our own experience with bulk power competition and institutions like independent system operators had not advanced to the point where the Commission felt comfortable being prescriptive. Today, with Order No. 2000 on the books encouraging the formation of regional transmission organizations (RTOs), the Commission is in a very different posture with respect to the structure of wholesale markets under RTOs.

Today, the Commission continues to regulate transmission and sale for resale activities in California's electricity markets, and the State continues to regulate retail activities. For example, sales of electricity to end users are retail sales, a matter left to the States under the FPA. States likewise have jurisdiction over local distribution facilities and the siting of generation and transmission facilities.

Let me emphasize two points. The Commission does not prescribe how states should open their retail markets. In addition, most states have been less prescriptive than California in telling the Commission how their wholesale markets should operate. Despite this, I think it is still fair to say that California and the Commission share the same goal – an electric industry that provides reliable and efficient service to consumers

at reasonable prices. The constructive working relationship developed between California and the Commission in recent years is particularly important as we seek to serve the public interest under conditions that stress the power system. The State and the Commission must continue to work together to ensure that any regulatory response to current events does not undermine reliability of the electric system or unduly delay the maturation of competitive wholesale electricity markets to the detriment of consumers.

It is my belief, and the position of the Commission, that consumers will benefit from competition in wholesale markets. Competition requires a sufficient number of competitors and a market structure and market "rules" that do not interfere with efficient market operation. In properly structured markets, wholesale buyers can choose from a wide range of sellers, and sellers can reach many more buyers. Effective competition can allow investment decisions to be driven by the market forces of supply and demand, not by regulatory decisions. The result is lower prices for wholesale buyers (and, ultimately, their end-use customers) than if we continued to rely on cost-based regulation of these markets.

However, the Commission's encouragement of competition in wholesale markets is not driven by a blind ideological devotion to deregulation. Instead, our policies are based on the practical belief that, in today's wholesale power markets, competition will produce the most benefits for consumers. Our goal, consistent with the FPA, is to use our regulatory authority to serve the public interest and ensure benefits for consumers, whatever approach that may require. In general, the Commission has adopted policies

that involve thorough regulation of access to, and prices for, essential transmission services; careful attention to mergers and other corporate consolidations that may concentrate generation markets; and relatively light-handed regulation of wholesale rates for sellers that lack market power.

Various parts of the country have different utility operations and business cultures, different market structures, and different retail competition policies. But, utilities are tied together commercially and operationally by a network of transmission that will support an ever-widening traffic in electrons in the years to come. Large regional markets can be made to work effectively. For example, in the case of Pennsylvania, whose utilities operate within the PJM Independent System Operator and whose retail customers were allowed to choose their power suppliers several years ago, the results contrast with what has happened in California. Pennsylvania's Department of Revenue estimates that, to date, the total benefit of competition over regulation to the state's gross state product is \$770 million. Individuals have saved \$562 million in inflation-adjusted dollars.

## **II. Rate Shocks This Summer in California**

Wholesale prices in California appear to have increased significantly this year, at least for the summer peak months. According to San Diego Gas & Electric Company, for example, prices in June and July of 1999 rarely exceeded \$150/MWh, while prices for the same period this year exceeded \$250/MWh in 167 hours and \$500/MWh in 59 hours. According to Southern California Edison Company, the total cost of electricity charged to

the California market for June 2000 was nearly half of California's total electricity cost for all of 1999.

In addition to price increases, California's retail consumers have increasingly been alerted of the risk of brownouts or blackouts. In mid-June, this risk was realized for thousands of consumers in the San Francisco area, during a virtually unprecedented heat wave.

These events have prompted a number of actions in recent weeks. Earlier this summer, for example, the ISO lowered the price at which it would buy certain types of energy from \$750/MWh to \$500/MWh, and later to \$250/MWh. In response, a market participant filed a complaint with the Commission, arguing that the ISO improperly exercised its authority to reduce the purchase price caps in its markets. The Commission resolved this case quickly, concluding that it need not evaluate the ISO's decision to lower the maximum price at which it will buy imbalance energy and ancillary services.

Recognizing the need for pro-active steps in California as well as other parts of the country, the Commission in late July directed its staff to investigate the conditions in bulk power markets in various parts of the country. Staff was told to determine any technical or operational factors, regulatory prohibitions or rules (Federal or State), market or behavioral rules, or other factors affecting the competitive pricing of electric energy or the reliability of service, and to report its findings to the Commission by November 1, 2000. In addition, I have asked staff to accelerate its investigation as it relates to

California and Western markets because the serious events here warrant special attention to California.

In July of this year, San Diego Gas & Electric Company filed a complaint with the Commission, seeking immediate imposition of a seller's price cap of \$250/MWh for all public utility sellers in the California ISO and PX markets. On August 23, the Commission ruled on this complaint. The Commission instituted formal hearing proceedings under FPA section 206 to investigate the justness and reasonableness of the rates of public utility sellers in the California ISO and PX markets, and also to investigate whether the tariffs, contracts, institutional structures and bylaws of the ISO and PX are adversely affecting the efficient operation of competitive wholesale power markets in California and need to be modified. The Commission was unable to grant SDG&E's request for a seller's price cap because it had not provided sufficient evidence to support immediate imposition of such a cap. However, the Commission left undisturbed the ISO's \$250 per MWh purchase price cap, and explained that this will serve to mitigate price volatility in both the ISO and PX markets. By establishing the hearing proceeding in the August 23 order, the Commission will have the ability under the FPA to order refunds, if appropriate, if it finds that rates for sales by public utilities to the ISO or the PX are unjust and unreasonable.

Other important actions were taken to provide more immediate relief to hard-hit retail ratepayers. For example, in late August, President Clinton extended \$2.6 million in federal emergency loans to low-income residents in the San Diego area to help pay their

electric bills. This amount doubled the funds that the affected region in Southern California receives under the LIHEAP program. The California Public Utilities Commission (CPUC) has authorized SDG&E to refund certain stranded cost overcollections to its customers, to help offset increased retail rates. Similarly, Governor Davis has recently signed legislation adopting a rate stabilization plan for San Diego customers and expediting the authorization of construction of new generation and transmission facilities. Finally, the CPUC, the California Electricity Oversight Board and the California Attorney General have undertaken investigations of the problems in the State's electric markets. The Commission welcomes all these measures. Now, we must focus on longer-term and structured market issues.

### **III. Possible Causes for the Problems**

As I noted, the Commission is undertaking careful and thorough investigations to address the recent problems in California this summer. I cannot prejudge the results of our investigative work. There are complex questions of fact involved. As a preliminary matter, however, there appears to be a select list of problem areas that command our closest scrutiny. Clearly, the problems that may have otherwise caused aberrant prices in California were exacerbated by the unusually high temperatures over the West, limiting California's ability to import power from neighboring states. Market-specific issues that are of more direct interest to the Commission include:

- o Most observers agree that additions of new generating facilities in recent years have not kept pace with rapidly rising electrical demand in California and neighboring states. Among other things, this limits California's ability

to import power from other states. The 12 percent estimated increase in California's electric demand since 1996 is unmatched by expansion of the infrastructure or means to manage the demand-side response;

- o inefficient market design including, for example, flawed rules for managing transmission congestion;
- o a lack of long-term contracting strategies for purchasing electricity;
- o a lack of demand-side response programs that would allow buyers to receive and respond to price signals, ensuring that both the demand and supply side of this market are fully functioning;
- o alleged collusion among sellers or other anticompetitive behavior by market participants;
- o little competition at the retail level by energy service providers; and,
- o transmission congestion that may have restricted imports.

A combination of these or other factors may have contributed to the problems California faced at various times. My preliminary view is that the fundamental issue is an overall imbalance of supply and demand. When demand increases and supply does not, prices can be expected to go up. The lack of adequate supply may be an inheritance from a pre-competitive era but it cannot be allowed to endure. Nevertheless, wholesale market rules and structure may have exacerbated the resulting price increases.

#### **IV. What Can the Commission Do and What Can It Not Do?**

The seriousness with which we view the situation in San Diego is shown by the Commission's quick resolution of the complaints filed with the Commission this summer. In the cases presented to us, the Commission still afforded the industry, market participants, and members of the public opportunities to comment on the complaints and

how the Commission should address them. Similarly, earlier this summer, the Commission carefully reviewed and approved the ISO's proposed demand response programs. These programs allowed the ISO to prearrange for load reductions from customers when necessary to meet peak demands. Tomorrow the Commission will be holding a public meeting here in San Diego to learn more about the problems in California's wholesale markets and hear what others recommend as appropriate courses of action.

The Commission is hard at work on completing its fact-finding investigation into California's wholesale markets. As soon as the staff provides its report to the Commission, the Commission is prepared to implement further measures, if appropriate, to address the issues we are discussing today. If we need to fix market rules or market structures within our jurisdiction, we will do so. If market power is being exercised as some have alleged, we will respond accordingly, by revoking market-based rates or otherwise. We may order refunds to the extent allowed by the FPA, if refunds are justified by record evidence. We also intend to act promptly on the recently-filed cases addressing these issues, and on any other filings that we may receive in the coming weeks.

However, the FPA defines the boundaries of the Commission's authority, and prevents us from taking certain actions that have been suggested. For example, we cannot change the rates, terms and conditions of services until we have a record supporting such action. Also, the statutes we implement do not permit us to order retroactive refunds of

amounts charged this summer to San Diego Gas & Electric Company. And, we cannot unilaterally change the status of municipal utilities.

## **V. What Can Others Do?**

Others also have a role to play. For example, the State of California should continue working to remove any unreasonable impediments to the siting of new generation and transmission facilities. The State also should ensure that State-regulated wholesale buyers can choose prudently among the full range of possible buying options, including entering into long-term contracts or into hedging arrangements. The State also should take further actions to facilitate demand response to prices through such measures as real-time metering, and encourage entry by retail competitors so that retail customers may be offered a broader array of pricing options.

Congress, too, has a role to play. In this industry, as elsewhere, uncertainty can deter new investments. I believe the uncertainty about Federal restructuring legislation is among the factors chilling investment in new generating and transmission facilities. As I have testified previously before this Subcommittee, I believe Congress should enact legislation that includes four main elements:

- (1) placing all electric transmission in the continental United States under the same rules for non-discriminatory open access and comparable service;
- (2) reinforcing the Commission's authority to foster regional transmission organizations;

(3) establishing mandatory reliability rules to protect the integrity of transmission service, relying on a self-regulating organization with appropriate Federal oversight of rule development and enforcement; and,

(4) providing the Commission with appropriate authority to remedy market power.

The other components of balanced restructuring legislation for the bulk power market are reform or repeal of the Public Utility Holding Company Act and clarification of Federal/State jurisdiction.

While each of these legislative reforms is important, the issues we are discussing today emphasize the Commission's need for effective tools to address market power. Currently, the Commission has only limited remedies available to address market power problems. The Commission can prevent enhancement of market power when utility mergers or other corporate transactions require authorization under FPA section 203. This remedy does not address market power that is already built into current commercial and operational arrangements, however. The Commission also can deny or revoke authorization for market-based wholesale rates. But, when this approach is employed to reimpose cost-based rates, the Commission does little or nothing to promote efficiency or competition. And, in California where generation plants have recently been sold at well above book value, cost-based rates may not represent a real reduction.

Reforms to the Federal statutory scheme are appropriate to permit regulators to keep up with the challenges posed by market power in evolving markets. Without such reforms, and without adequate remedial authority, market power could be used to impair

competition and the related benefits to consumers. For example, the Administration's bill would even allow the Commission to address market power in retail markets, if asked to do so by a state lacking adequate authority to address the problem. The Administration's bill would also give the Commission explicit authority to address market power in wholesale markets by requiring a public utility to file and implement a market power mitigation plan. I believe it would be helpful to close these gaps in the Commission's remedial authorities, and to provide future protections in circumstances like those in California.

## **VI. Conclusion**

Recent events cast doubt on anyone's ability to predict or prevent aberrant prices in complex electricity markets. Price spikes are a timely reminder that, while we are involved in the intoxicating work of re-inventing a major industry, we must look diligently after consumer needs throughout this difficult transition. We must do so because electricity is so essential to people that it cannot always be rationed purely by price. We must also do so to ensure that competitive market initiatives are not summarily reversed before their benefits to the public become real and apparent.

In conclusion, the Commission remains committed to effective competition in wholesale power markets, as the best means to ensure reasonable rates for electricity. If competition is not working well, our current investigations will allow us to identify the problems and take appropriate remedial action.

Thank you.

